Chief Executive's Statement

In last year's annual report, I predicted the global macro environment and financial markets in 2015 would become more complicated and volatile than 2014. It turned out market conditions in 2015 were indeed much more complicated and volatile than I expected. While technically speaking there was no financial crisis, market conditions were precarious. Sentiment was mainly affected by three negative factors — unbalanced and unconventional monetary policies, continued weak fundamentals in developed countries, and gloomy outlook for the emerging markets.

Monetary policies adopted by the major central banks had become more divergent since 2015. For most part of the year the US Federal Reserve wavered between "to hike or not to hike", before it finally decided to raise the policy rate in December, signalling the start of interest rate normalisation. On the other hand, both the eurozone and Japan entered an era of negative interest rates. Amid the expectations of US interest rate hikes, US dollar continued to strengthen, resulting in the depreciation of other currencies and, indirectly, a sharp fall in commodity prices. Crude oil prices plunged from over US$100 a barrel in mid-2014 to below US$30. Global equity markets were generally on an upward trend in the first half of the year with stock market indices in Mainland China and Hong Kong rising markedly. However, the momentum was short-lived. Within three months the Hong Kong and Mainland stock markets had plummeted, with the Hang Seng Index registering the largest quarterly fall of over 5,000 points in the third quarter. Amid the falling equity prices and the renminbi exchange rate reform, market concerns over the outlook of the Mainland economy continued to grow and were in the spotlight of the financial markets, particularly in the second half of 2015.

The gloomy mood in global financial markets continued into 2016 and affected the Hong Kong dollar exchange rate, which at one point approached the weak-side Convertibility Undertaking level of 7.85 against the US dollar. Coupled with the bearish views of some overseas investment funds on the Hong Kong dollar, and some hedge funds betting on the Hong Kong dollar de-pegging from the US dollar, rumours spread quickly that financial predators were launching an attack on the Hong Kong dollar, like what they did in 1998. To quell the speculation, the HKMA sent timely messages to the markets and the public through various channels, stating clearly that the robustness of Hong Kong's financial systems had strengthened significantly since the Asian financial crisis in 1997-98; the Aggregate Balance of the banking system, the Monetary Base and the foreign currency assets in the Exchange Fund had grown considerably since then; and the HKMA was fully ready to deal with any significant outflow of funds. These timely assurances, supported by well-substantiated arguments, quickly restored market confidence.

Banking stability is a core element in the maintenance of financial stability. We have consistently emphasised the importance of taking preventive measures to strengthen Hong Kong banks' resilience against any shocks arising from US interest rate normalisation and changes in the global macroeconomic environment. The over-heated property market continued to be our supervisory priority. Since 2009 the HKMA has introduced seven rounds of countercyclical prudential measures, the latest round being launched in February 2015. As a result, the average loan-to-value ratio of new residential mortgages dropped to 50% at the end of 2015, 14 percentage points lower than the ratio in 2009. The average debt servicing ratio of new residential mortgages also dropped 7 percentage points to 34% in December 2015 from 41% in August 2010. Banks and property buyers are now far more resilient to any shocks caused by a downward cycle in the property market.

In addition to the countercyclical measures, the HKMA has been working in full swing to implement the Basel III capital and liquidity requirements with a view to further enhancing the financial robustness and resilience of the banking system. We closely monitor banks' lending business and their resilience against abrupt changes in the markets through our day-to-day supervisory work, such as stress-testing and thematic supervision. As the banking system has a substantial exposure to Mainland-related lending, we have strengthened our supervisory efforts — through regular surveys, establishment of a database, more in-depth and granular analyses of the loan quality — to ensure banks have taken comprehensive and prudent credit risk management measures.

The overall loan quality of the banking industry remains sound although it deteriorated slightly in 2015. Retail banks' classified loan ratio edged up to 0.70% at the end of 2015 from a very low level of 0.52% at the end of 2014.

There was significant progress in the legislative work to reform the banking system. We completed the drafting of the Financial Institutions (Resolution) Bill and introduced it into the Legislative Council last December. The Bill seeks to implement international requirements to reduce the risk posed to the financial system by the "too big to fail" financial institutions. Another amendment bill, aimed at improving the Deposit Protection Scheme, was also introduced into the Legislative Council in November to streamline the payout process and further strengthen public confidence in the banking system.

2015 also saw remarkable achievements in the development of Hong Kong's financial infrastructure. The Payment Systems and Stored Value Facilities Ordinance came into effect, providing a legal framework for the healthy development of the retail payment industry in Hong Kong. The HKMA has been in close contact with the industry to prepare for the licensing and future day-to-day supervisory work that supports industry development while safeguarding public interest. The e-Cheque service was also successfully launched during the year, offering individuals and corporations an efficient, safe and cost-effective alternative to traditional paper cheques.

The HKMA has been actively promoting the development of Hong Kong as a regional hub for corporate treasury centres. Our objective is to attract multinational enterprises to conduct their group treasury management activities in Hong Kong, thereby strengthening the role of Hong Kong as an international financial centre. Apart from active involvement in the legislative process to create an enabling tax environment, we are also lobbying and encouraging multinational corporations to set up their corporate treasury centres in Hong Kong.

We are pressing ahead with the promotion of financial inclusion. In view of the inadequate provision of basic banking services in some remote or under-served areas, the HKMA has been encouraging the banking industry to open more physical branches or make use of new technology, such as video teller machines or mobile branches, to provide these services.

To further enhance the soft power of Hong Kong's banking sector, we adopt a three-pronged strategy — enhancing the competence of industry practitioners; improving the corporate governance of banks; and promoting consumer education. In collaboration with the industry, we are introducing a series of Enhanced Competency Framework to provide training programmes, examinations and accreditation for banking practitioners. Initially the framework for private wealth management has been launched, and we are working on the framework for practitioners engaged in anti-money laundering and counter-terrorist financing. We have also enlisted the help of experts to study how the role of independent non-executive directors can be strengthened to improve the corporate governance of banks; and on consumer education, we have employed both traditional media and social networking platforms to encourage the public to be smart and responsible in the use of banking products and services.

2015 was an eventful year for the development of offshore renminbi business in Hong Kong. The International Monetary Fund's decision to include renminbi in its Special Drawing Rights (SDR) currency basket has far-reaching significance for the internationalisation of renminbi. Indeed, the Central Government highly commended Hong Kong for its role as an offshore renminbi centre and for its invaluable contributions to the inclusion of renminbi in the SDR basket.

Following the reforms to the renminbi exchange rate fixing mechanism in August, market expectations about the renminbi exchange rate have changed markedly. Also triggered by other factors, the offshore renminbi liquidity pool in Hong Kong contracted by 13% year-on-year to about RMB1 trillion, and offshore renminbi interbank rates rose sharply in January 2016. Thanks to the various renminbi liquidity facilities put in place earlier, Hong Kong's offshore renminbi market continued to operate in an orderly manner and helped extend the much needed liquidity to other offshore markets, underscoring Hong Kong's position as the world's leading offshore renminbi centre.

2015 was an extremely challenging year for the investment of the Exchange Fund. A prolonged period of excess liquidity resulted in huge market volatilities and the rare case of a "triple whammy", where all three major asset classes, namely equities, bonds and foreign currencies, plummeted in tandem. In this erratic environment, even a conservative fund like the Exchange Fund unavoidably recorded a loss of HK$15.8 billion, or an investment return of -0.6%. Nevertheless, the loss was relatively mild compared with that of some major investment funds and market indices.

Apart from a series of timely defensive moves to help mitigate potential investment losses, we have quickened the pace of asset diversification. In particular, newly approved private equity and real estate investments under the Exchange Fund's Long-Term Growth Portfolio were doubled to US$9.7 billion in 2015. Since its inception, this portfolio has recorded an annualised internal rate of return of 12%.

The Exchange Fund is not an ordinary profit-oriented investment fund because its main statutory purpose is to maintain monetary and financial stability. As global financial markets enter a post-quantitative easing era, characterised by "low return and high volatility", the safest and most responsible approach is to adhere to the principle of "capital preservation first, long-term growth next" and avoid pursuing short-term returns by taking excessive risks.

Looking ahead, we should expect heightened uncertainty in the macroeconomic environment in 2016. As market sentiment remains fragile and jittery, any slight signs of trouble could trigger strong reactions in financial markets. At the time of writing my statement, market views on the pace of interest rate hikes in the US this year are still quite diverse. But we must be prepared. Depending on the size of the interest rate differentials between the Hong Kong dollar and the US dollar and other fundamental factors, outflows from the Hong Kong dollar will occur sooner or later. The Hong Kong dollar may weaken to touch the weak-side Convertibility Undertaking of 7.85, mostly likely during turbulent times. Yet the triggering of the weak-side Convertibility Undertaking is, by design, a necessary step in the normalisation process of Hong Kong dollar interest rates. The key is that Hong Kong's financial system is resilient enough to withstand volatile capital flows. The HKMA's determination and ability to maintain the Linked Exchange Rate System are beyond doubt.

Recently, there have been suggestions calling for adjustment to the HKMA's countercyclical measures for the property market. The average residential property transaction volume in Hong Kong between last August and December decreased by more than 30% compared with the period between January and July. Property prices in the secondary market also fell. However, judging from past experience in the property market, short-term movements may not provide a sufficient basis for assessing clearly the market trends ahead. We need to observe market developments for a longer period before we can be certain that the property market has entered a downward cycle. Nevertheless, we will closely monitor the property market and take appropriate measures as and when needed to maintain banking stability.

Norman T.L. CHAN
Chief Executive